

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

22

1 particular input was not homogenous, could not easily be
2 substituted from one industry to another in its same
3 form, would you expect that the prices for the input
4 would vary between those industries?

5 A Well, under that -- under the assumption that
6 you've just given me, they are economically distinct
7 goods.

8 Industry A can only use blue widgets and
9 Industry B can only use green widgets, and there's no
10 particular reason, unless I know something about the
11 costs, to expect the prices to be the same.

12 They're different -- you've just told me
13 they're different goods.

14 Q Would you also agree that different sectors of
15 the economy experience different rates of technological
16 change?

17 A Yes.

18 Q Would that have an input on the -- I'm sorry.
19 Would that have a effect on the prices of
20 inputs to those different sectors?

21 A That's a very complicated question.

22 It depends in part on sort of where the change
23 comes from, whether it's driven by suppliers, whether
24 it's driven by the sector itself.

25 The nature of the change, whether it's a
26 change in operating methods or whether it's a change in
27 durable equipment -- there's no obvious connection that
28 I can see -- although there may be in particular

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

23

1 cases -- between rates of technical progress and rates
2 of change in input prices, although under some
3 assumptions I suppose there might be.

4 Q You said it depends in part of where the
5 change comes from?

6 A I did say that. Yes.

7 Q And why would that have an effect on whether
8 the input-price rate changes or not?

9 A The -- well, I think for a moment about the
10 computer industry, all right, where -- which is
11 generating internally advances in cost of computing --
12 falls in the cost of computing.

13 There's an industry with high productivity.
14 It's not obvious to me that that change has -- the fact
15 that it's generating technological change internally has
16 any particular implications for its input prices.

17 Now consider an industry -- banking -- that is
18 a heavy user of computer technology.

19 Well, banking productivity may be enhanced by
20 the availability of cheaper computer power.

21 It may be possible -- I mean properly
22 measured, that's an input price change, but it may also
23 permit productivity growth within banking.

24 So in that case the availability of a better
25 input, a cheaper input, may -- besides itself
26 contributing to cost reduction, may contribute to change
27 within the sector whereas in computers I don't see any
28 relation between input prices and productivity change.

1 Q Okay. You just touched on something I'm going
2 to get into in just a moment.

3 A I try to be helpful.

4 Q Let me get to --

5 Would you agree that different industries by
6 their very nature use different mixes of inputs?

7 A I think I answered that in the affirmative a
8 few minutes ago, yes.

9 Q So, for example, education and health care are
10 fairly labor-intensive industries; is that right?

11 A Yes.

12 I hesitate a bit because both use fair amounts
13 of capital, in fact; and health care is using more over
14 time, but I'll --

15 Q Okay.

16 A -- take the assumption for the sake of
17 argument.

18 Q Telecommunication is itself a fairly
19 capital-intensive industry?

20 A It's more capital intensive as those two, as I
21 understand, today.

22 Q If the cost for labor inputs were rising more
23 rapidly than the cost of capital inputs as a general
24 matter, isn't it true that industries, such as health
25 care, that are labor intensive would be expected to
26 experience higher input-price growth than other
27 industries that are relatively capital intensive?

28 A Under that set of assumptions, that's

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

25

1 correct.

2 Q Now, as a general matter, isn't it true that
3 the outputs of one industry can be the inputs to
4 another?

5 A Yes.

6 Q You're familiar with the term intermediate
7 goods?

8 A Yes.

9 Q Can you just define for us what intermediate
10 goods are?

11 A An intermediate good, or, for that matter,
12 service, is -- is something produced -- is purchased by
13 another -- by a business and used in the production
14 process. It's not purchased by -- it's almost easier to
15 define as what it's not.

16 It's not purchased by a consumer. In the
17 national accounts, it's not purchased by a government
18 agency, and it's not an investment good.

19 Q In the case of intermediate goods, then, the
20 rate of price growth could either constitute input-price
21 growth or output-price growth depending on whose view
22 you're looking at in time; is that right?

23 A That's correct.

24 Q Let me ask you a hypothetical along those
25 lines, then.

26 Let's assume there's an industry, we'll call
27 it Industry A, that uses only one input to produce its
28 output, and we'll call that Service A.

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

26

1 Also assume that the one input that Industry A
2 utilizes is the output of another industry, which we'll
3 call Industry B.

4 Now, let's assume that the rate of price
5 growth for the output of Industry B was less than the
6 national inflation rate.

7 Do you have that in mind?

8 A I'm trying to keep it in mind. Yes, sir.

9 Q Well, if you lose me, just let me know.

10 Under those conditions, assuming that
11 hypothetical, isn't it true that one would expect that
12 Industry A would experience input-price growth less than
13 the national inflation rate?

14 A If I understand your hypothetical, you assumed
15 that. You said it is one input that grows at less --
16 that has a price growth of less than the national
17 average, and then you asked me if it has input-price
18 growth less than the national average.

19 Yes, I think that follows tautologically from
20 the --

21 Q Okay. Now, as I understand it, you agree with
22 Dr. Christensen's finding that the long-term
23 productivity growth rate for the national LEC industry
24 is approximately 2 percent greater than the rate of
25 productivity growth for the economy as a whole; is that
26 right?

27 A That's correct.

28 Q So based on that, you would expect that over

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

27

1 time the rate of growth in the prices of LEC services
2 would be roughly 2 percent less than the economy-wide
3 inflation rate; is that right?

4 A That's correct.

5 Q That follows from assuming that
6 Dr. Christensen is correct.

7 A Yes.

8 Q Suppose that there was a particular industry
9 whose only output was telecommunications services
10 produced by the LECs; wouldn't it then follow that the
11 long-term rate of growth of input prices for this
12 particular industry would be the same 2 percent less
13 than the economy-wide inflation rate?

14 A It was -- let me just make sure I understand
15 your hypothetical.

16 Q Uh-huh?

17 A An industry that purchases only -- no labor,
18 only LEC outputs.

19 Q That's right.

20 A And it purchases them in the same proportions
21 as the LEC produces them, otherwise we have potential
22 changes in relative prices.

23 Under those two assumptions, it has
24 input-price growth less than the national average,
25 that's correct, by roughly 2 percent.

26 Q All right.

27 Turn to page 12 of Exhibit 2, Attachment 1.

28 Do you have that in front of you?

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

28

1 A Yes.

2 Q In the first full paragraph on that page you
3 characterize input-price indices as being constructive
4 as a by-product of TFP studies; isn't that right?

5 A That's right.

6 Q And then you go on to state in the next
7 sentence that input prices are used in a TFP study to
8 calculate the relative weights of different inputs used
9 in construction of the quantity index of aggregate
10 input; is that right?

11 A Right.

12 Q Can you explain what you mean by that second
13 sentence?

14 A In a TFP study, particularly as regards to the
15 capital input, which is what this is primarily concerned
16 with, one weights a quantity index of aggregate or of --
17 a -- one weights -- sorry. Let's step back.

18 The rate of growth of inputs is obtained as a
19 weighted average of the rates of growth of the
20 quantities of particular inputs.

21 On the capital side, quantity growth,
22 particular assets, is computed directly, as I think is
23 indicated on the on the next page of this -- the weights
24 are user cost weights, and input prices are used to
25 calculate the user cost weight using the formula down at
26 the bottom of that page.

27 Q Now, you said the weights are user cost
28 weights but you refer to them in your testimony as

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

29

1 expenditure weights.

2 Can you explain the different, if any?

3 A Well, you -- you use user cost to construct --
4 well, let me be sure I have this correct.

5 My concern in doing this, of course, was the
6 price index rather than the TFP study.

7 The -- let me be sure I understand this.

8 You use -- no, I'm sorry. Just a minute.]

9 Can I take a quick look at some notes?

10 This is always one of the things it is easy to
11 get confused on, expenditures versus unit cost.

12 The appropriate -- the input price change
13 is -- the rate of growth of input is a weighted average
14 of rates of growth of physical input quantities weighted
15 by the share of each input in total cost.

16 The user cost times the amount of capital is
17 capitals component, so to speak, used in computing that
18 expenditure share.

19 So similarly, one uses a quantity of labor
20 times an average wage rate, the quantity of capital
21 input times the user cost and so forth.

22 Q So this is what you mean when you say the
23 expenditure weighting is the product of the input prices
24 and the quantities; is that right?

25 A Yes. Only in the case of capital, which is
26 what is under consideration here, it is a user cost.

27 Q Now, the weighting of the various input has a
28 direct impact on the quantity index of aggregate input;

1 isn't that right?

2 A That's correct.

3 Q And TFP is simply the difference in growth
4 rates between the output quantity and the input
5 quantity, isn't that right?

6 A Right.

7 Q By directly impacting the quantity to have
8 aggregate input, the weighting of the various inputs has
9 a direct impact on the measure of TFP that is calculated
10 in a TFP study?

11 A The issue is a quantitative one given -- it
12 does as a matter of arithmetic have an impact, but a
13 relatively large percentage change in a weight can end
14 up having a relatively small percentage impact in TFP,
15 but it will have an impact.

16 Q Why don't you turn back to Exhibit 1,
17 Attachment 1, page 15. Do you have that in front of
18 you?

19 A Yes.

20 Q Near the bottom of the page, there is a
21 statement that says:

22 "A possible rationale for a
23 special California stretch is the
24 fact that at the time incentive
25 regulation was first adopted the
26 growth in California's
27 telecommunications industry greatly
28 exceeded the national average

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

31

1 industry growth."

2 Do you see that?

3 A Yes.

4 Q You go on right after that to assert some data
5 with respect to the output of Pacific Bell and the U.S.
6 telecommunications industry prior to 1990. And again
7 you refer to changes after 1990. Do you see that?

8 A Yes.

9 Q And that is particularly shown in the chart
10 that is on page 16?

11 A Correct.

12 Q As corrected this morning.

13 A Yes.

14 Q Now, the numbers that you put forth there as
15 far as the level of output growth for both Pacific and
16 the U.S. telecommunications industry, where did you get
17 those numbers from?

18 A Footnote 26, I believe, explains where those
19 notes come from, where those numbers come from.

20 Q You have to bear with me for a moment. I
21 didn't see Footnote 26 in the text of the document.
22 That is why I didn't refer to it when I was reading the
23 testimony.

24 Is it identified in the text of the document?

25 It is in the title. I didn't see it there. You didn't
26 see it either.

27 Just to be clear, when you said in that
28 statement about prior to 1990 the growth in California's

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

32

1 industry being greater than the national average
2 industry, your reference to California's
3 telecommunications industry was to Pacific Bell, is that
4 right?

5 A That's correct.

6 Q Not to any other companies in California?

7 A That's correct. And I think

8 Footnote 26 makes that explicit.

9 Q And the reference to the national or -- well,
10 you say national average industry growth, and you
11 further refer to it as U.S. telecommunications output
12 growth, refers to the major LECs that Dr. Christensen
13 studied, is that right?

14 A Yes.

15 Q Those are the seven RBOCs plus GTE?

16 A That is consistent with my recollection.

17 Q You would agree there are other
18 telecommunications providers in the national
19 telecommunications industry besides the major LECs,
20 isn't that right?

21 A That is certainly correct. There are
22 interexchange carriers that could perhaps more properly
23 be labeled as output growth from local exchange
24 companies in California, et cetera, et cetera.

25 Q What about cellular companies? Would they
26 fall in that national telecommunications industry?

27 A If one wanted to do the national
28 telecommunications industry as opposed to comparing

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

33

1 local exchange providers, you would include cellulars.

2 Q Do you believe that the aggregate industry
3 output growth of this broader telecommunications
4 industry that I just referred to is fairly represented
5 by the output growth rates of just the major LECs?

6 A I think for the purpose this figure was drawn,
7 which is comparing among local exchange providers, this
8 is a fair comparison.

9 If one for another purpose wanted some broad
10 measure of how much telecommunications was happening in
11 the economy, one would want to broaden it. For but for
12 the purpose for which this was done, I think this is the
13 right comparison.

14 Q But putting that aside for the moment, do you
15 believe that if we took a broader measure of national
16 telecommunications industry beyond the seven LECs, would
17 the output growth rate of that broader industry be
18 fairly represented by the figures you have shown here
19 for just the LECs?

20 A If one wanted to measure the broader
21 aggregate, I haven't studied the question, I think the
22 broader aggregate grew more rapidly as a general
23 matter. I don't know how much more rapidly. But I
24 haven't studied it. And that is not a firmly based
25 opinion.

26 Q We are moving along fairly well. I apologize
27 for jumping around, but I am going to go back to
28 Exhibit 2 again, this time to page 8 of the attachment.

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

34

1 I could tell by the seven years you spent in
2 San Diego and the rest of your career that you are very
3 anxious to get back to Cambridge probably and get out of
4 this state.

5 A No. It was very difficult leaving San Diego,
6 I must say. For any place but MIT, I don't think I
7 would have left.

8 Q At the bottom of page 8 of Exhibit 2,
9 Attachment 1, you discuss the recent FCC price cap
10 order. Do you see that?

11 A Yes.

12 Q You make a point here that the election by the
13 LEC is to be done on an annual basis, is that right?

14 A That's my understanding, yes.

15 Q In its first election, Pacific Bell chose the
16 5.3 percent productivity factor with no sharing, is that
17 right?

18 A Right.

19 Q And it is your understanding that Pacific can
20 change that next year if it chooses to, right?

21 A That's my understanding, yes.

22 Q Assume, if you will, without getting into any
23 question of whether this is true or not, but assume that
24 Pacific, in deciding what to select as its price cap
25 election with the FCC, had forecast this year that it
26 would have earnings of more than 15 percent. Do you
27 have that assumption in mind?

28 A I have that assumption in mind.

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

35

1 MR. SASSER: Can I seek a clarification? Are you
2 talking about in the interstate jurisdiction?

3 MR. FABER: Yes.

4 Q It would have an incentive, would it not,
5 given that assumption, to select the 5.3 percent
6 productivity factor with no sharing?

7 A That's correct. I think that's basically
8 shown on Table 1 a couple pages later.

9 Q And similarly, if it had forecast that its
10 earnings would be, say, 9 percent, it would have an
11 incentive to choose the lowest productivity factor of
12 4 percent with the highest level of sharing, isn't that
13 right?

14 A Again, with the clarification that you are
15 talking interstate rate of return, that's correct.

16 Q Now at the bottom of page 8 of that Exhibit 2,
17 Attachment 1, you make a statement about the revenue
18 neutral effect of the IRD rate rebalancing. Do you see
19 that?

20 A Yes.

21 Q And you assert there that the demand
22 stimulation the Commission expected from decreases to
23 toll and carrier access prices has not materialized.

24 A Yes.

25 Q Do you know what level of demand stimulation
26 the Commission forecast in the IRD proceeding for toll
27 price reduction?

28 A Yes. My understanding is that the Commission

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

36

1 assumed a price elasticity of about .5. And based on
2 conversations with Pacific personnel, it is my
3 understanding that the demand stimulation that has
4 occurred, which did indeed occur fairly rapidly after
5 the roughly 40 percent drop in rates, was consistent
6 with the significantly smaller elasticity.

7 Q Have you done any study on your own of what
8 the stimulation effect has been of the toll reductions
9 that took place on January 1st?

10 A I have not personally done such a study, no.

11 Q Who did you talk to at Pacific Bell about
12 this?

13 A I think I talked to Mr. Evans. I believe I
14 also talked to Dr. Tardiff. I think Dr. Tardiff has
15 looked at this question. I discussed this with him. In
16 fact, I discussed this with him initially since he
17 drafted this footnote, and I said "How do we know this?"
18 And he went through the arguments that he looked at the
19 data. He is a very reliable person. I relied on him.

20 Q Mr. Tardiff told you that he had done a study
21 of the demand stimulation that had occurred, or he spoke
22 to someone at Pacific about it?

23 A I don't recall now which it was, whether he
24 had himself looked at the numbers or done a formal study
25 or talked to someone. I have the sense that he had seen
26 the numbers in initial conversations. I believe I had
27 more recent conversations with people at Pacific.

28 Q That last sentence to me was important. You

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

37

1 do believe you spoke to someone at Pacific, or
2 Mr. Tardiff did?

3 A I believe that after I spoke with Mr. Tardiff
4 and after this was filed, I think I have discussed this
5 with people at Pacific.

6 Q Do you believe as a matter of economic
7 principle that it would be reasonable for stimulation
8 effects from a toll rate reduction to occur only eight
9 months after the reduction was put into place?

10 MR. SASSER: I will object. I think we are
11 starting to get pretty far afield. We are not going to
12 litigate this particular issue in this proceeding. It
13 is just simply a footnote to a statement that is talking
14 about the general principle of revenue neutrality in the
15 IRD rate proceeding.

16 I don't think that this witness is prepared to
17 litigate the effects of demand stimulation versus the
18 revenue neutral approach the Commission intended to
19 take.

20 MR. FABER: Your Honor, if I might. I would be
21 perfectly happy if Mr. Sasser strikes this footnote from
22 the testimony, but it is his witness who raised it. It
23 is Pacific Bell that is attempting to litigate this in
24 another proceeding and bringing it up in this
25 proceeding.

26 I didn't raise it. I didn't put it into
27 testimony. And I am entitled to ask questions about the
28 basis for this.

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

38

1 I am intending, quite honestly, if he doesn't
2 voluntarily withdraw it, to move that this footnote be
3 stricken from the testimony since Dr. Schmalensee just
4 testified he doesn't have any factual basis for this
5 assertion.

6 But I don't want this footnote to be put into
7 this record and then have it somehow brought into the
8 record in the IRD proceeding where Pacific has now
9 sought modification of last year's IRD decision.

10 MR. STOVER: Your Honor, may we be heard briefly on
11 this?

12 ALJ REED: Yes.

13 MR. STOVER: We would also request that Pacific
14 strike this footnote; and if not, we will join in the
15 motion to strike based on the testimony we have just
16 received.

17 ALJ REED: Let me be clear about what you said,
18 Mr. Faber. Notwithstanding whether or not you are able
19 to or allowed to go further with questions with
20 Dr. Schmalensee about this footnote, you want to strike
21 it?

22 MR. FABER: I would like to strike it, yes.

23 ALJ REED: Mr. Sasser.

24 MR. SASSER: Your Honor, as I said, I think the
25 context in which this appears is not an attempt to
26 litigate this. It is simply an attempt to acknowledge
27 that the Commission intended in the IRD rate proceeding
28 for there to be a revenue neutral balance, rate

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

39

1 rebalancing, and that it does not appear that that has
2 been the case.

3 I think in the context in which it appears it
4 is entirely appropriate. It is not an attempt to
5 litigate the issue.

6 It appears only in the footnote and as a
7 passing matter to a statement that did not want to leave
8 the impression that in fact the Commission had achieved
9 that revenue neutral rate rebalancing.

10 MS. BURDICK: Your Honor, we would join the large
11 telecommunications users and AT&T in moving to strike.
12 This isn't an issue of whether Pacific intends to
13 litigate this or raise this as a significant issue in
14 this case. It is presented as a matter of factual
15 evidence that the demand stimulation the Commission
16 expected from the toll and carrier access price
17 reductions has not materialized. That could potentially
18 affect the Commission's decision in this case. Yet as
19 this witness has testified, there is no substantive
20 evidence which he has relied upon in drawing that
21 conclusion. Lacking foundation, it should be stricken
22 from the record.

23 MR. SASSER: Your Honor, the witness has stated
24 basis for the statement, and it should stand on its
25 own.

26 MS. GRAU: Your Honor, DRA would join in the motion
27 to strike since this is an independent issue raised by
28 both Pacific and GTE in their joint petition and the

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

40

1 replies, responses to that petition are coming soon.

2 Again, as has been stated by Ms. Burdick, the
3 statement is one of fact, and this witness has offered
4 nothing other than the belief that he has talked to
5 someone in Pacific and Dr. Tardiff to bolster that
6 fact.

7 ALJ REED: Mr. Sasser.

8 MR. SASSER: I have nothing further to add.

9 ALJ REED: We will strike Footnote No. 7.

10 MR. FABER: Your Honor, I'm almost finished. Did
11 you want to take a brief break while I just go through
12 my notes?

13 ALJ REED: Not right yet, Mr. Faber.

14 MR. FABER: Can I have just a moment to look over
15 my notes?

16 ALJ REED: Please.

17 MR. FABER: Thank you.

18 Q Dr. Schmalensee, could you turn to page 13 of
19 your reply, Attachment 1. Near the top of that page you
20 say that measuring rates of return or capital on
21 economic depreciation is difficult and highly
22 contentious.

23 Do you see that?

24 A Yes.

25 Q And then you go on to say that developing
26 price indices for telephone plant and equipment is not
27 an easy task. Do you see that?

28 A Yes.

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

41

1 Q You use the phrase TPI to refer to those
2 indices, correct?]

3 A Yes.

4 Q What do you mean when you say that the
5 development of price indices for TPI is not an easy
6 task. Why is it so complicated?

7 A Because the equipment changes over time.
8 There are quality changes, and properly -- I mean, it's
9 the usual reason why price indices are difficult when
10 the quantity, the products whose prices are being
11 measured change; the index is complicated.

12 Q Are you saying then that the results of
13 developing a TPI index might raise a lot of questions
14 about whether it might have been accurately done?

15 A One can argue over price indices in a range of
16 settings, unless a setting in which one can argue
17 because of the importance of adjusting for quality
18 change and the fact that there are changes in quality,
19 there are obviously performance measures that can assist
20 in that task.

21 I'm not an expert on how well or how poorly it
22 can be done or has been done in this industry. This was
23 just intended to be a general statement alluding to the
24 problems we have just discussed.

25 Q Have you ever personally developed a TPI
26 series for an LEC?

27 A No, sir; I have not.

28 Q Would you expect that TPIs would differ

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

42

1 significantly than the same cost category from one LEC
2 to another?

3 A I'm not sure I understand precisely what you
4 mean by "cost category."

5 This is a subset of telephone plant equipment,
6 switch gear, something like that.

7 Q Well, no. In preparing a TFP study, TPIs are
8 generated for different categories of costs, central
9 office equipment for example.

10 A Okay. Okay, yeah.

11 Q Would you expect that the TPIs would vary
12 significantly for the same cost category across LECs?

13 A Well, in principle, the price index -- again
14 for this purpose -- ought not to be heavily
15 LEC-specific. So I haven't -- if you do them for
16 specific LECs, however, one could expect them to vary as
17 different within broad categories. Different LECs make
18 different strategic choices, face different operating
19 problems, find themselves with long-term relationships
20 with different suppliers whose performance varies.

21 So there are a lot of reasons why it could
22 vary for different LECs, particularly in the short run.

23 MR. FABER: Thank you, Dr. Schmalensee.

24 That's all the questions that I have.

25 ALJ REED: Okay. Why don't we take a 10-minute
26 break and then we'll begin with you Ms. Burdick.

27 (Recess taken)

28 ALJ REED: On the record.

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

43

1 Ms. Burdick.

2 MS. BURDICK: Thank you, your Honor.

3 CROSS-EXAMINATION

4 BY MS. BURDICK:

5 Q Dr. Smalensee, I'm Lee Burdick. I'm counsel
6 for CCTA this morning.

7 How are you holding up this morning?

8 A I think I'm all right.

9 Q I would like to direct your attention to
10 Attachment 2 of Exhibit 1, your direct prepared
11 testimony, specifically your curriculum vitae. I notice
12 on page 1 that you received an S.B. degree in economics,
13 politics and science from MIT in 1965; is that accurate?

14 A That's right.

15 Q And you received your Ph.D from MIT; is that
16 correct?

17 A That's correct.

18 Q Is the S.B. also the equivalent of a Bachelors
19 of Science degree?

20 A For some reason MIT says S.B. for B.S.

21 Q That's been my experience as well.

22 Did you secure a Master's Degree on your way
23 to a Ph.D?

24 A No. That's relatively uncommon in economics,
25 then and now.

26 Q Just so we're singing from the same sheet of
27 music, would you agree with me that by this Commission's
28 definition, Category 3 services are services that are

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

44

1 deemed to be freely competitive?

2 A That's consistent with my understanding of
3 Category 3 -- I don't know that I've seen exact
4 language -- yes.

5 Q Is it also your understanding that this
6 Commission has determined that Category 2 services are
7 services which are only partially competitive?

8 A Again, that's consistent with my
9 understanding, yes.

10 Q And is it your understanding that this
11 Commission has defined or regulates Category 1 services
12 as being monopoly services?

13 A Yes.

14 Q For the year ending December 31st, 1994, do
15 you have any understanding as to what percentage of
16 Pacific Bell's revenues came from Category 1 services?

17 A I think it's stated in the attachment to the
18 prepared testimony. I think it's around 80 percent or
19 higher --

20 Q Could you direct --

21 A -- for Category 1.

22 Q I'm sorry. Could you direct me to where in
23 your prepared testimony it refers to that percentage?

24 A I can try.

25 MR. SASSER: Perhaps I can help, your Honor.

26 It's stated on Footnote 14, page 10.

27 ALJ REED: Thank you, Mr. Sasser.

28 MS. BURDICK: Q Now, where does that number come

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

45

1 from, Dr. Smalensee?

2 A That number came from Pacific Bell. Exactly
3 who, I'm not sure. But we asked for this number, and we
4 received a revenue breakdown billed and booked.

5 I believe this reflects the booked percentage,
6 but I'm not positive. There was a bit of a difference,
7 but --

8 Q What percentage as of December 31st, 1994, of
9 Pacific's revenues came from Category 2 services?

10 A I don't have that breakdown. I don't know.

11 Q What about Category 3 services?

12 A I don't know.

13 Q Now, was it your understanding that, as of
14 January 1, 1995, that the intraLATA toll market was open
15 to competition?

16 A It's my understanding, yes.

17 Q Now, as of the second quarter of 1995 ending
18 on June 30th, what percentage of Pacific's revenues were
19 attributed to monopoly services?

20 A I haven't seen numbers from 1995. I simply
21 don't know.

22 Q And that would be the same for Category 2 and
23 Category 3 services?

24 A That's correct.

25 Q Now, is it your understanding that, as of
26 January 1, 1996, that the local exchange markets will be
27 open to competition in California?

28 A That's my understanding, yes.

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

46

1 Q Is it also your understanding that the
2 Commission currently has several proceedings going on
3 regarding the effect that local competition will have,
4 particularly on the regulation of the LECs?

5 A Yes.

6 Q Would it be fair to say that, as you sit here
7 today, it's impossible to predict what percentage of
8 Pacific's revenues will be derived from Categories 1, 2
9 or 3 services for the first two quarters of 1996?

10 A Well, it's impossible to predict most things,
11 in my experience, with a high degree of precision. So I
12 guess, yes, but most other things are also impossible.

13 I think a fair characterization is that there
14 is a good deal of uncertainty that surrounds those
15 percentages as in 1996.

16 Q Let me direct your attention to Exhibit 1,
17 the -- what appears to be the true testimony of --
18 page 1, the second answer on the first page where you
19 make reference to:

20 ". . . business and society as a
21 whole can benefit immensely when
22 economic regulation is simple,
23 predictable and grounded in sound
24 economic principles."

25 Do you see that?

26 A I see it.

27 Q Is it your opinion that the current price cap
28 framework is too complex?